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BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

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In the Matter of

1998 Biennial Regulatory Review --
Review of Depreciation Requirements
for Incumbent Local Exchange Carriers

Forbearance From Depreciation Regulation
of Price Cap Local Exchange Carriers

CC Docket No. 98-137

ASD 98-91

**COMMENTS
of the
GENERAL SERVICES ADMINISTRATION**

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Summary

Until such time as competition provides an effective control over LEC prices, the Commission must continue to regulate the LECs in an efficient manner. Because there are a number of situations in which depreciation can affect LEC prices, the Commission must continue to impose constraints on the carriers' ability to adjust depreciation rates.

The Commission's formal prescription of depreciation rates can be eliminated, however, so long as the depreciation parameters selected by a LEC are publicly reported and within the ranges prescribed by the Commission. The Commission should continue to collect the information necessary to maintain the currency of its depreciation parameter ranges.

GSA urges the Commission to provide more information to the public concerning proposed changes in its ranges, but does not oppose the change proposed for digital switching. GSA strongly supports the expensing of salvage and cost of removal.

Finally, because there are a number of situations in which depreciation can affect LEC prices, the USTA Petition to forbear from regulating depreciation should be rejected.

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COMMENTS

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GENERAL SERVICES ADMINISTRATION

The General Services Administration ("GSA") submits these Comments on behalf of the customer interests of all Federal Executive Agencies ("FEAs") in response to the Commission's Notice of Proposed Rulemaking ("NPRM") released October 14, 1998. The NPRM invites comments on Commission proposals to further streamline the depreciation rescription process. GSA will also comment on the Petition filed by the United States Telephone Association ("USTA") requesting that the Commission forbear from regulating the depreciation and amortization practices of local exchange carriers ("LECs") subject to price cap regulation.¹

I. INTRODUCTION

Pursuant to Section 201(a)(4) of the Federal Property and Administrative Services Act of 1949, as amended, 40 U.S.C. 481(a)(4), GSA is vested with the responsibility to

¹ Public Notices released September 29 and October 16, 1998.

represent the customer interests of the FEAs before Federal and state regulatory agencies. The FEAs require a wide array of interexchange and local telecommunications services. From their perspective as end users, the FEAs have consistently supported the Commission's efforts to bring the benefits of competitive markets to consumers of all telecommunications services. Until such time as competition provides an effective control over LEC prices, however, the Commission must continue to regulate the LECs in an efficient manner.

Pursuant to the Notice of October 16, 1998, the FEAs comments will first address the NPRM and then, in a separate section, the Petition by the USTA.

II. COMMENTS ON THE NPRM

A. Constraints on Depreciation Rates Continue To Be Required For Incumbent Local Exchange Carriers

Depreciation is a non-cash expense that serves as an offset to earnings. As depreciation is increased, earnings are reduced, and vice versa. Since most of the carriers discontinued accounting under Financial Accounting Standard No. 71 ("FAS 71"), the setting of depreciation rates for regulatory purposes bears no necessary relationship to the reporting of earnings to shareholders and to the financial community.² As a consequence, carriers have no incentive with respect to regulatory depreciation rates other than to adjust them to the maximum advantage of shareholders. As long as it is feasible to game the

² FAS 71 allows regulated companies to use the accounting prescribed by regulators in their financial reports as long as there is a reasonable assurance that regulation will provide the cash flows necessary to fulfill the regulatory prescriptions.

regulatory system through adjustments in depreciation, the Commission must continue to impose constraints on the carriers' ability to adjust depreciation rates.

Both the Commission and USTA correctly observe that the need to prescribe depreciation rates has diminished with the implementation of price cap regulation without earnings sharing. This diminution has justified the much more relaxed constraints on depreciation rates that the Commission has implemented in recent years.³ But there are still situations where regulatory depreciation rates can make an important difference to a price cap carrier and to the general public that uses that carriers' services. In the NPRM, the Commission identified five: (1) a calculation of a low-end adjustment, (2) a recalculation of the productivity factor, (3) an exogenous cost determination, (4) a calculation of the Base Factor Portion that is used to determine how much a carrier can recover through End User Common Line charges, and (5) the cost support a carrier would have to provide if it proposed an Actual Price Index higher than its Price Cap Index.⁴ To these might be added the situation when a carrier initially proposes a new interstate access service for which a base-line rate must be established. Each of these situations would offer the opportunity for a carrier to manipulate costs, and hence rates, if it had no constraint on its ability to set depreciation rates.

The FEAs submit that there is no condition under which a carrier might be able to set its own depreciation rates without compromising the Commission's oversight. The suggestion of BellSouth that carriers be allowed to set their own depreciation rates on the

³ See, e.g., Simplification of the Depreciation Prescription Process, CC Docket No. 92-296, Report and Order, FCC 93-452, released October 20, 1993.

⁴ NPRM, para. 6.

condition that they renounce their entitlement to a low-end adjustment is without merit.⁵ Carriers may make that promise, but the "takings" provisions of the Fifth Amendment to the Constitution guarantees that if severe financial difficulties arise, that promise can be voided. Any company that is forced by regulation to suffer such reduced earnings that its ability to maintain credit and attract capital is compromised has a right to appeal to regulators for relief.⁶

**B. The Commission Must Continue to Collect Information
On Plant Life and Retirement Experience**

The FEAs are sympathetic to the carriers' and the Commission's desire to reduce the burden of depreciation documentation and reporting. While not objecting specifically to the report simplification proposals in the NPRM, the FEAs point out that the Commission must continue to monitor plant life and retirement trends in order to maintain the currency of its depreciation parameter ranges. While those ranges appear appropriate at the present time, there will be no means to ensure their continued propriety if the Commission ceases to gather any further data on life and retirements trends. At a minimum, those data should include reports on the retirements of plant from each plant account, preferably by vintage. It would also be beneficial for the Commission to continue to receive the results of actuarial studies of at least the major mass property accounts. It would be useful as well to obtain descriptions of the trends in technology and replacement of the plant categories such as switching and circuit equipment for which technological

⁵ Id., para. 8.

⁶ Federal Power Commission v. Hope Natural Gas, 320 U.S. 591, 604 (1944).

development is the principal driver.

The format, periodicity and even the reporting entity for this information is a matter of Commission discretion. Certainly, the past requirements for detailed, carefully formatted triennial studies by company, by "study area," (usually state), now seem unnecessarily complex. Possibly consolidated information by region, or even the entire nation (for accounts that lack any regional cost distinctions) would suffice. The important point is that the Commission must not deprive itself of the information necessary to ensure the currency and propriety of its plant account life ranges. The FEAs are concerned that the pressure to simplify reporting and reduce regulatory burdens on the carriers may result in an inadvertent loss of the informational resources needed to maintain even a minimal level of oversight of carrier depreciation rates and practices.

C. Prescription of Within-Range Depreciation Factors Is Not Needed, but Reporting of Those Factors Is

The Commission proposes to eliminate its past practice of prescribing depreciation life parameters so long as those parameters are within the range established by the Commission.⁷ The FEAs agree that the prescription procedure is an unnecessary burden on the Commission. However, the FEAs urge the Commission to continue the requirement that carriers report publicly their depreciation parameters and rates so that users and competitors can have the opportunity to understand the changes in the carriers' costs as reported to the Commission and as used for the various regulatory purposes discussed above.

⁷ NPRM, para. 10.

**D. Further Information Is Required to Assess the Propriety
Of Any Change in Equipment Life Ranges**

The Commission proposes to maintain the present life ranges with the exception of digital switching equipment, for which the lower end of the range would be reduced from 16 to 13 years.⁸ As support for this proposal, the Commission notes that retirement rates for digital switching equipment have nearly doubled since the early 1990s and are now approximately three percent. The Commission requests comment on this proposal, with the admonition that commenters should provide justification for their proposals.

Superficially, a retirement rate of three percent hardly justifies a reduction in the digital switching equipment life parameter to 13 years. If that rate of retirements were maintained, the average life of this equipment would be 33 years (the reciprocal of .03). There undoubtedly is much more refined and relevant information that supports the Commission's proposal; otherwise the Commission would not make it. However, that information is not available to the FEAs, or any other non-carrier party for that matter. For this reason, the FEAs must "pass" on any recommendation, pro or con, regarding the propriety of the life parameter ranges proposed by the Commission.

The FEAs are concerned, however, that with the present dearth of public information, the only parties that can offer supported proposals for changes in the ranges of depreciation parameters are the carriers. Those parties are hardly objective. Therefore, if the Commission seeks a balanced review of the depreciation parameters, it must provide more in the way of public information than is offered in the NPRM. Otherwise, it must rely solely on its own staff to provide the necessary balance against the biases of the carriers

⁸ Id., para. 11.

in determining the propriety of its prescribed ranges of depreciation parameters.

E. Salvage and Cost of Removal Should Be Expensed

The FEAs strongly support the Commission's proposal to treat salvage and cost of removal as current expenses rather than as elements of depreciation.⁹ The FEAs endorse the reasoning for this recommendation: that the estimation of net salvage is complex, inexact, and imposes substantial burdens on both carriers and state and federal commissions.

The FEAs suggest yet another reason to eliminate net salvage from the depreciation process, which is that the conventional practices for computing net salvage contain a bias toward overstatement. The depreciation study format that was previously prescribed by the Common Carrier Bureau's Accounting and Audits Division required the carriers to present two displays of gross salvage and cost of removal for each depreciable plant account. Table A presented the annual retirements, gross salvage, and cost of removal. Table B presented the Table A information in five-year overlapping bands. The final column of each table showed the ratio of net salvage to retirements. It was from this last column that the salvage ratios were usually selected. While these tables are no longer presented to the Commission, the calculations contained in them continue to be the basis for the salvage ratio ranges currently prescribed by the Commission and the ratios requested by the carriers.

⁹ Id., para. 14.

The ratios compare dollar amounts from very different time periods. The retirements are quantified at their original cost, which for long-lived plant can be several decades ago. They thus reflect the value of dollars in previous years. The salvage and removal costs are, of course, current data, reflecting the recent value of the dollar. Due to the effect of past inflation, the numerator of the salvage ratio is therefore in dollars of much lower value than the denominator, with the result that the ratio is higher than if all dollars were rendered into a constant value. The result is a ratio that incorporates past inflation and, when applied as an adjustment to the depreciation rate, projects that inflation into the future.

Arguably, it might be appropriate to project inflation into removal costs on the theory that this is a more accurate representation of the actual future cost of removal than a current dollar estimate. This rationale ignores the fact that the funds collected today to offset future costs are retained by the carrier until those costs are incurred. Meanwhile they accrue return, which offsets the effect of inflation. But disregarding even that faulty rationale, the fact is that inflation has declined in recent years. A projection of the loss in value of the dollar during the past 20 years into the next 20 years likely overstates the prospective effect of inflation - even if it were appropriate to reflect that effect.

As long as salvage ratios reflect the Table A and B calculations, they are biased toward overstatement. With the decline in inflation, that bias is becoming more severe. For this reason, as well as those cited in the NPRM, the FEAs strongly urge the Commission to adopt its tentative decision to expense net salvage.

The effect of this conversion to salvage expensing will be to leave a reserve excess in the accounts that in the past were calculated with high negative salvage ratios. These

are principally in the outside plant category: poles, cables and conduits. Fortunately, the Commission-approved remaining life procedure has the effect of amortizing those reserve excesses over the remaining life of the plant. No explicit adjustment to the carriers' depreciation reserves has to be made for this change.

III. COMMENTS ON THE USTA PETITION

In its Petition, USTA requests the Commission to forbear from regulating depreciation at all on the rationale that such regulation is no longer needed. In the view of the FEAs, the Commission's NPRM adequately answers this proposal. It identifies five situations in which depreciation might be relevant to the continued Commission oversight of the interstate services of incumbent local exchange carriers on price cap regulation.¹⁰ To these five, the FEAs have suggested a sixth, and that is in the establishment of new rates for interstate access services not previously offered.

While it is true that the Communications Act requires forbearance from regulation whenever regulation is no longer needed, the Commission's survey of its depreciation requirements clearly indicates that some constraints are still required over the ability of the incumbent carriers to set their own depreciation rates.

The FEAs therefore urge the Commission to reject the USTA Petition.

¹⁰ Id., para. 6.

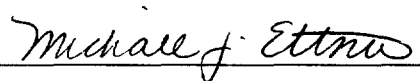
VI. CONCLUSION

As a major user of telecommunications services, GSA urges the Commission to streamline the depreciation prescription process as recommended herein and reject USTA's Petition for forbearance.

Respectfully submitted,

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November 23, 1998

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